THE CITY OF SAN DIEGO

MANAGER'S REPORT

DATE ISSUED: September 9, 2004 **REPORT NO.** 04-200

ATTENTION: Honorable Mayor and City Council
Docket of September 13, 2004

SUBJECT: Sewer System Financing Program – Initial Approval of Documents

REFERENCE: City Manager's Report 01-209, issued October 10, 2001
City Manager's Report 03-037, issued February 26, 2003
City Manager's Report 03-120, issued June 11, 2003
City Manager's Report 04-115, issued June 2, 2004

SUMMARY

Issue - Should the City Council adopt an ordinance (a.) approving the form of and authorizing the issuance of Sewer Revenue Bonds and/or Subordinated Sewer Revenue Bonds (collectively, "Bonds") by the Public Facilities Financing Authority of the City of San Diego ("Authority") to finance upgrades to and expansion of, and to refund certain outstanding obligations of the Sewer System in an amount not to exceed $1.2 billion; (b.) approving the form of an Indenture between the Authority and the Trustee; (c.) approving the form of and authorizing the execution and delivery of a 2005 Supplement to the Master Installment Purchase Agreement (MIPA) between the City and the Authority; (d.) authorizing the investment of a portion of the proceeds of the Bonds in instruments with a term of maturity in excess of five years; and (e.) authorizing the City Manager or his designees to take such actions, and to execute such documents as may be necessary to complete the sale and issuance of the Bonds and/or the insuring of all or a portion of the Bonds and/or the refunding or refinancing of all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Bonds in addition to the mandatory retirement of the 2004 Non-Transferable Subordinated Sewer Revenue Bonds?

Manager's Recommendation – Adopt the ordinance.

Other Recommendations - None.

Fiscal Impact - Issuance of between $400 million and $1.2 billion (depending on market conditions, the number of months of construction that are financed, and whether all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Bonds are refunded to achieve interest cost savings in addition to the mandatory retirement of the 2004 Non-Transferable Subordinated Sewer Revenue Bonds) of one or more series of parity and/or subordinated bonds will result in annual debt service payments of approximately $25.3 million - $68.5 million over a thirty year period, subject to market rates at the time of sale. It is anticipated that if all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Bonds are refunded with new bonds paying lower interest in addition to the mandatory retirement of the 2004 Non-Transferable Subordinated Sewer Revenue Bonds, annual debt service cost savings of as much as $2.9 million per year could be realized. All related costs of issuance, including but not limited to underwriters, bond counsel, trustee, and preparation of the Official Statement will be reimbursed from bond proceeds.

BACKGROUND

In October of 2001, the City Council approved increasing all sewer service charges by 7.5% on March 1, 2002, 2003, 2004 and 2005 to ensure continued compliance with the requirements of the Clean Water Act, the Ocean Pollution Reduction Act (OPRA), the State Ocean Plan, the National Pollutant Discharge Elimination System (NPDES) permit, and the federal Stipulated Final Order for Injunctive Relief (Stipulated Order). In connection with approval of the aforementioned service charge increases, the City Council was advised that it would be necessary to issue additional sewer revenue bonds on a periodic basis which, in combination with additional pay-as-you-go funding derived from rates, would provide the required project financial support.

In June of 2003, as part of the ongoing wastewater project, the City Council took a series of actions related to the issuance of sewer revenue bonds and/or subordinated sewer revenue bonds for purposes of (1) financing the fifth phase of the approved wastewater system capital improvements program, and (2) refunding all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B sewer revenue bonds to realize interest cost savings. Pursuant to those actions, staff proceeded to complete the steps necessary to effect the public sale of the bonds through UBS Financial Services on September 9, 2003. As a result of the discovery of certain errors in the City’s FY 2002 Consolidated Annual Financial Report, and the related Annual Financial Report of the Wastewater Utility (as more fully set forth in a Voluntary Report of Information filed by the City in January of 2004), a decision was made not to go forward with that bond issuance.

In June of 2004, the City Council, in consideration of the facts that, as described above, the City is under several obligations which require the construction and renovation of numerous capital facilities on an established schedule, and that the delay in issuance of bonds had resulted in cash flow pressures which required mitigation, adopted a resolution authorizing the issuance, on an interim, private placement basis, of $152 million in non-transferable subordinated revenue bonds which would be subject to mandatory retirement by means of a subsequent public offering of long-term debt.

DISCUSSION

The Bond Authorization Process

The decision to utilize an interim private placement financing was based solely on the fact that the 2003 wastewater audited financial statements would not be available in time to effect a public market financing on favorable terms. The proposed bond issue is being managed as a two part process to minimize lost time in accessing the public markets at a time of increasing interest rates. At the same time, it will insure that any and all actions necessary to provide accurate and complete disclosure and minimize interest and insurance costs will have been taken.

The first phase of the two-part process consists of the adoption of an authorizing ordinance (which is subject to a 60-day validation period which must be allowed to run its course prior to the sale of bonds), approval of the form of an indenture and the form of a 2005 supplement to the MIPA, and authorizing the City Manager or his designees to take such actions, and to execute such documents as may be necessary to complete the sale and issuance of the Bonds and/or the insuring of all or a portion of the Bonds and/or the refunding or refinancing of all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Bonds in addition to the mandatory retirement of the 2004 Non-Transferable Subordinated Sewer Revenue Bonds. The second phase, consisting of the approval of a preliminary official statement, bond purchase agreement and other documents, is accomplished by means of a resolution which is not subject to validation, and can therefore be undertaken much later in the process without adversely affecting the date of sale.

The two-part process described above is particularly apropos to the management of this offering, whose favorable marketplace reception is tied to FY 2003's audited financial statements, which are not yet available. The FY 2003 wastewater financial statements audit being performed by the accounting firm of KPMG, LLP, while well along, is not yet complete. It will, however, be completed and its results incorporated in the preliminary official statement presented to the City Council as part of phase two of the approval process, tentatively scheduled for November.

The Proposed Issuance

The issue size of the Bonds is expected to be between $400 million and $1.2 billion, secured by installment payments to be made by the City exclusively from net system revenues of the Sewer Fund. The actual principal amount of the Bonds will be determined by the level of interest rates at the time the Bonds are priced in the marketplace, the number of months of construction that are financed, and whether it is in the best economic interest of the City to refund all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Bonds in addition to the mandatory retirement of the 2004 Non-Transferable Subordinated Sewer Revenue Bonds to achieve lower interest costs. Assuming 24 months of construction are funded, it is anticipated that the issue size will be approximately $407 million, resulting in annual debt service payments of approximately $25.5 million. It is anticipated that if all or a portion of the previously issued 1993, 1995, 1997 Series A/B and 1999 Series A/B Bonds are refunded in addition to the mandatory retirement of the 2004 Non-Transferable Subordinated Sewer Revenue Bonds, the issue size and annual debt service payments could increase to as much as $1.2 billion and $68.5 million respectively. Refunding outstanding bonds with new bonds paying lower interest would partially offset these costs however, with annual debt service cost savings of as much as $2.9 million per year being realized.

As was the case with previous issuances, the 2005 Bonds will be used to fund a part of the Council-approved wastewater capital improvement program consisting of numerous projects, including the repair and replacement of aging and deteriorating components of the Sewer System, upgrades to facilities to meet requirements of the Clean Water Act, OPRA, the State Ocean Plan, the NPDES permit and the Stipulated Order, as well as to meet the needs of current and future residents and commercial customers. Approval of the Bond documents today will facilitate the financing of projects through FY06. Future rate increases and bond issuances will be necessary to complete this program.

Financing Documents

The documents being submitted for approval at this time will enable the Authority to issue Sewer Revenue Bonds, Series 2005 and/or Subordinated Sewer Revenue Bonds, Series 2005 (collectively, “Bonds”) in the Fall of 2004, as described above. The Ordinance approves the form, execution and delivery of financing documents and certain other actions within the City Manager’s purview and limitations, which are necessary and in the best interests of the City, to issue no more than $1.2 billion in bonds. A brief description of the major financing documents follows:

> **Indenture** - This document outlines the Authority’s and Trustee’s rights, responsibilities, and obligations with respect to the issuance of the 2005 Bonds.

> **2005 Supplement to the Master Installment Purchase Agreement of 1993** - Specifies which components of the overall capital program will be funded and the terms and conditions governing repayment of the Series 2005 Bonds.

Proposed Financing Structure

The proposed financing vehicle for the FY05-06 sewer capital program is sewer revenue bonds. Revenue bonds are issued to fund capital improvements and debt service is paid from and secured by a pledge of the gross or net revenues of the enterprise. It is anticipated that the Bonds will be issued by the Authority. The Authority was created by the City and its Redevelopment Agency to engage in financing activities and is administered by a commission which is comprised of three members of the public, the City Treasurer, and the Assistant Executive Director of the Redevelopment Agency of the City of San Diego.

The five previous sewer financings in 1993, 1995, 1997, 1999 and 2004 utilized revenue bonds delivered by the Authority. The City entered into an installment purchase agreement in which the Authority agreed to acquire or construct various capital facilities (projects) using revenue bond proceeds and then sell the projects to the City. The City makes installment payments and pays all other expenses associated with the financing and the properties.

The 1993, 1995, 1997 and 1999 bonds were issued using a senior lien structure under which bondholders were promised that they would be first to receive interest and principal payments once operating and maintenance expenses were met, and that rates would be set at levels sufficient to ensure that sewer revenues of at least 1.2 times the principal and interest amount due each year would be available to make those payments (the coverage covenant). The 2004 non-transferable bonds were issued using a subordinated lien structure, as described below.

The same subordinate lien structure utilized for the 2004 non-transferable bonds is being contemplated for this financing, and will be employed if market conditions permit. A subordinate lien is "subordinate" primarily because the buyers of these securities receive principal and interest payments only after operating and maintenance expenses are paid, and the City's senior lien obligations are met. From the City's standpoint, the use of a subordinate lien structure can increase management flexibility because the debt service coverage requirements and other covenants are typically less stringent than under a senior lien structure. Debt service coverage covenants typically applicable to subordinate lien structures are 1.1 times principal and interest, and sometimes as low as 1.0 times principal and interest. A lower coverage covenant means less pressure to raise rates simply to meet coverage requirements.

CONCLUSION

It is recommended that the Council authorize the issuance of Bonds in an amount not to exceed $1.2 billion and approve the related financing documents so that the next phase of improvements to the wastewater system and the refinancing of all or a portion of the previously issued 1993, 1995, 1997 Series A/B, and 1999 Series A/B Bonds, in addition to the 2004 Non-Transferable Subordinated Sewer Revenue Bonds to produce interest cost savings may proceed.

ALTERNATIVE

Do not approve the requested actions. This is not recommended because of its adverse effect on the Metropolitan Wastewater Department's ability to execute its ongoing capital improvement program and the City's ability to reduce its wastewater-related debt service costs by as much as $2.9 million per year by refinancing certain of the Sewer System's preexisting obligations.

Respectfully submitted,

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Mary Vattimo	Approved: Patricia T. Frazier
City Treasurer	Deputy City Manager

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